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Russian Federation

HRI Food Service Sector

Opportunities for U.S. Foods Sales in the Russian Market

2007

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Report Highlights:

With a population of 143 million, increasing consumer income and growing food expenditures, the picture for HRI-oriented product sales in Russia is bright indeed. Many restaurants import a vast majority of their ingredients (up to 90%), and present growing opportunities for producers, particularly in the meat, seafood, wine and specialty food categories. U.S. producers face substantial competition in restaurant produce, and perception of American products continues to be somewhat negative. Difficulties with customs, port delays and protectionism all present challenges, but the size and growth of the HRI sector makes Russia a valuable market for U.S. food products.

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Executive Summary

The HRI sector is one of the fastest growing segments of the Russian economy and is experiencing growth rates of 20-30% per year. There are significant opportunities for American producers to benefit from this boom, as many importers, distributors and managers in the HRI segment have expressed an interest in new product offerings and high-quality ingredients.

Most of the growth in the HRI sector is occurring in the fast food and casual dining segments. The majority of HRI customers are price sensitive, but very interested in new and innovative products. As the Russian restaurant culture grows in sophistication, the demand for different products increases.

To succeed, American exporters must be prepared to do extensive marketing, and educate potential clients about the uses for their products. Logistics can be a problem, especially as shipping traffic overloads the port in St. Petersburg, the primary gateway for American food imports. American products also face substantial competition from Western Europe, Asia, and South America.

While the main market for American products is still in Moscow and St. Petersburg, the HRI sector is developing rapidly in the larger cities, such as Kazan, Nizhny Novgorod, Yekaterinburg, and tourist cities on the Black Sea such as Sochi. Operating outside of the major regions, however, adds an additional layer of logistical complication for American exporters and a strong importer or distributor is needed.

Section I: Market Summary and Structure

The Russian economy is experiencing rapid economic growth overall (estimated at 7% in 2006), but the HRI sector is growing even faster at 23-26% annually. Russians now spend more of their income on food than any other country in Europe, and dining out is beginning to replace the home as the preferred venue for entertaining. Even so, there is still considerable room for expansion, as the number of restaurants and hotels in Russia still lags behind other countries. The first wave of restaurants was generally located in the city centers of Moscow and St. Petersburg, but new restaurants are opening in suburbs and smaller cities across Russia as people start to view dining out as a regular event rather than a special occasion. New shopping centers also play a role, as market studies indicate that up to one quarter of restaurant visits in 2006 were associated with a shopping center. Customers like the convenience and choice of the new centers, and restaurants often find it easier to set up in a center, as the infrastructure is already in place. One restaurant chain owner reported that unlike his other restaurant locations in the city, the purpose-built space in a shopping center allowed him to properly ventilate his kitchen.

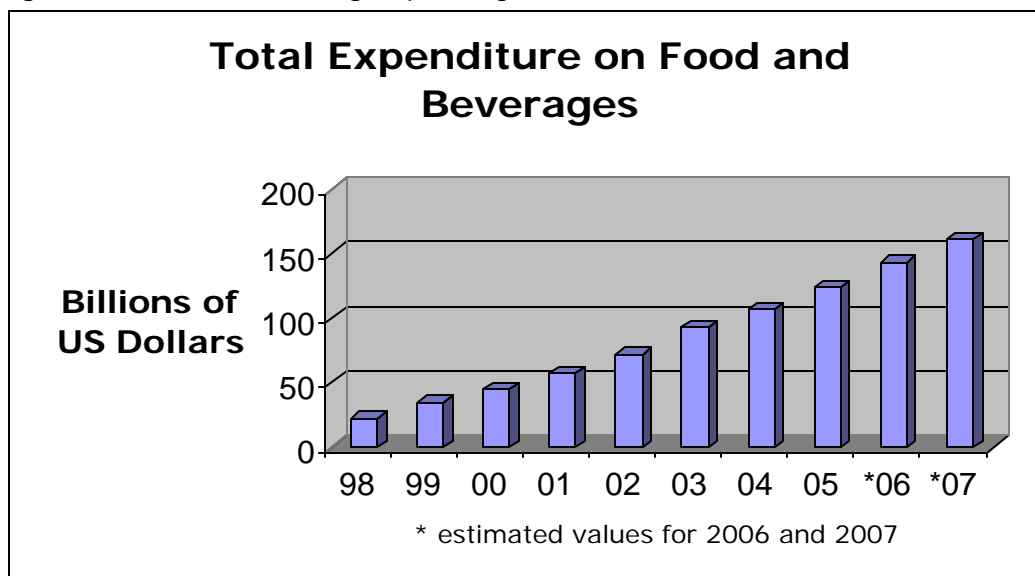
As more women enter the work force, more and more people are eating their main meals in restaurants, and dining out for lunch. Business lunches are a standard option in many mid-range restaurants. There is an increasing trend toward health consciousness and lower calorie options, especially with younger demographic groups. Fast food is the fastest growing segment, but also (perhaps counter intuitively) subject to the same health conscious trends as other foods. McDonalds began including calorie information on its packaging in Russia in 2006, and other fast food restaurants and cafes have reported increased sales of healthy menu offerings.

The Russian consumer is also traveling more as a result of the improved economy, and is exposed to a wider variety of tastes and foods that they want to experience at home. As a result, today's Russian diner is exploring new and international cuisines. Italian, Caucasian,

and Japanese restaurants are particularly popular. Russian menus are also quite extensive, and consumers tend to order multiple courses, even in fast-food restaurants.

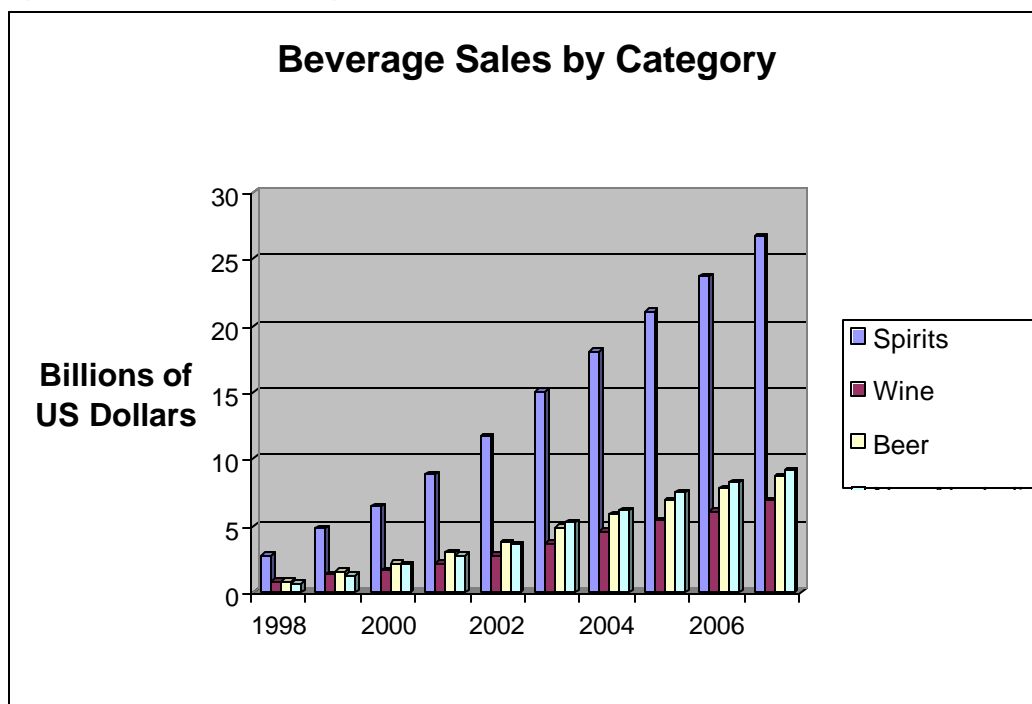
Alcohol spending is also increasing, but trending away from the traditional vodka. Beer and wine are becoming increasingly popular, as are “aspirational” drinks such as brandy, cognac and tequila.

Figure 1: Food and Beverage Spending in the Russian Federation



Source: Euromonitor

Figure 2: Russian Beverage Sales



Source: Euromonitor

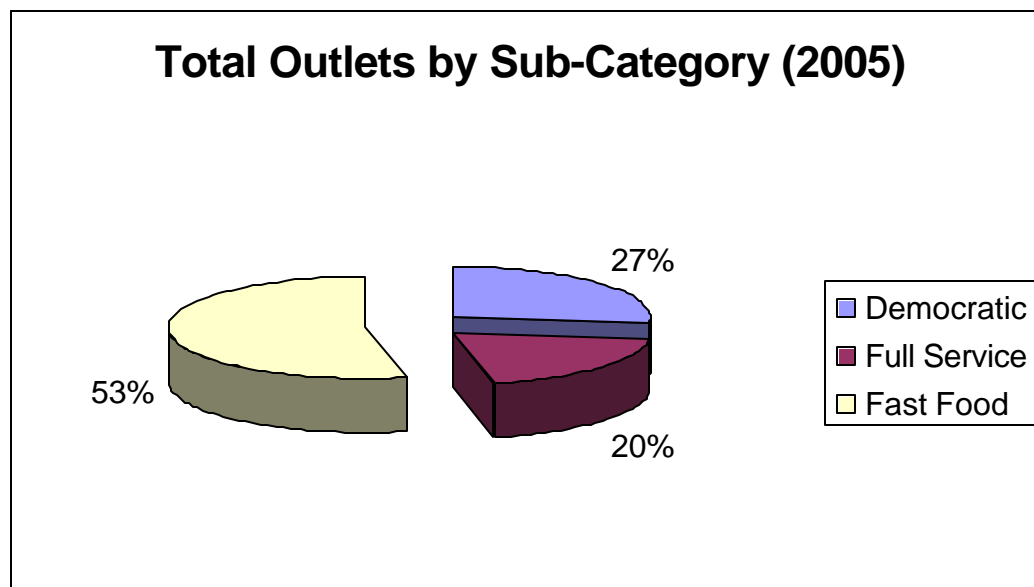
HRI Subsectors

Restaurants

The Russian restaurant market has grown considerably in the past few years, but is still small compared to other cities of its size and the market is nowhere near saturation. While Moscow and St. Pete are still the largest restaurant cities, there is strong expansion into other cities such as Yekaterinburg, Vladivostok, and many of the smaller regions, particularly in the south.

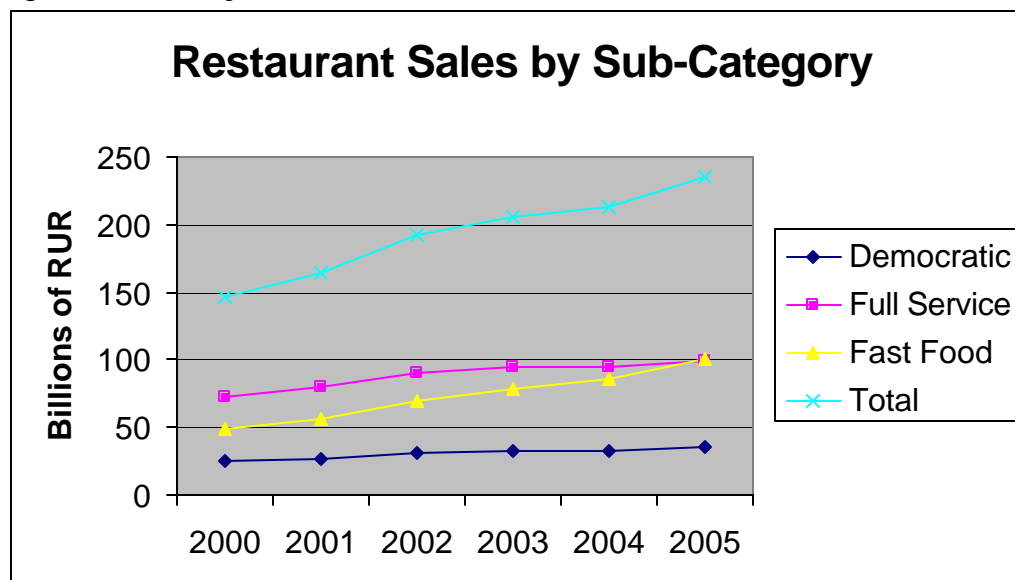
There is disagreement about how many restaurants are in Moscow. The Moscow city government estimates that there are approximately 10,000 restaurants in the city, and that they had gross earnings of US \$2.5 billion in 2005. This figure, however, does not take into account closures, and may be high. Industry experts believe the actual number of restaurants, excluding street vendors and institutional venues such as office cafeterias, to be closer to 4,500, but that the turnover figures are reasonable. Customers spent US \$3.52 billion dollars in restaurants in Moscow in 2006, mostly in casual dining restaurants and quick service establishments. The most active segments were the coffee shop and casual dining sectors, with profits of 38 and 32 percent. Profits in the fast food sector were also growing at a rate of 26% in 2006, and show strong promise in other regions. Profit growth in fine dining is smaller, but still substantial at 9%. Total revenue across all segments grew at 16% in 2006, and the number of customers is increasing at the rate of 3-5% annually.

Figure 3: Eateries by Sub-Category



Source: Industry data and expert opinion

Figure 4: Sales by Sub-Sector



Source: Industry data and Euromonitor

Fine Dining/Full Service Restaurants

The haute-cuisine, fine dining restaurants with their accompanying expensive checks are the stereotypical image of the Russian HRI sector. In some ways, the stereotype is true; there is no shortage of extravagant and luxury restaurants in Moscow and St. Petersburg. This category was the first to develop in the mid 1990's, but most experts agree that the high-end restaurant sector is saturated. While growth may be slower than in other segments, there is still an opportunity for U.S. products, particularly as these restaurants demand higher quality foods and are less price sensitive than the casual and fast food eateries.

Meats, seafood, wines and spirits, and nuts are all items that sell well. Many restaurants import their produce, but require very fresh fruits and vegetables that are usually sourced from Europe. Higher end restaurants are more loyal to their suppliers, but will not hesitate to change if the quality deteriorates or is inconsistent.

Casual, "Democratic" Dining and Cafes

The mid-range, "democratic" restaurant segment in Russia is developing quickly. Many notable restaurateurs from the haute cuisine category are opening up mid-priced options, and having a chain of these is somewhat trendy. The average price for a meal at one of these restaurants is between \$12-50, making this segment far more accessible to the growing middle class than the haute cuisine sector. Growth rates for democratic restaurants are between 15-20% annually.

Despite the name, many of the chain restaurants act as a chain in name only. Very few have any system of centralized purchasing, and most decisions regarding products and purchasing are made at the restaurant level. Each restaurant may use separate suppliers and ingredients, even if the menu is somewhat standardized. This acts as both a blessing and a curse for those wishing to sell to this segment. On one hand, there are many more opportunities for sales since each restaurant is a separate account. On the other, individual sales are smaller, and do not allow for the development of exclusive distribution rights and consistent volumes.

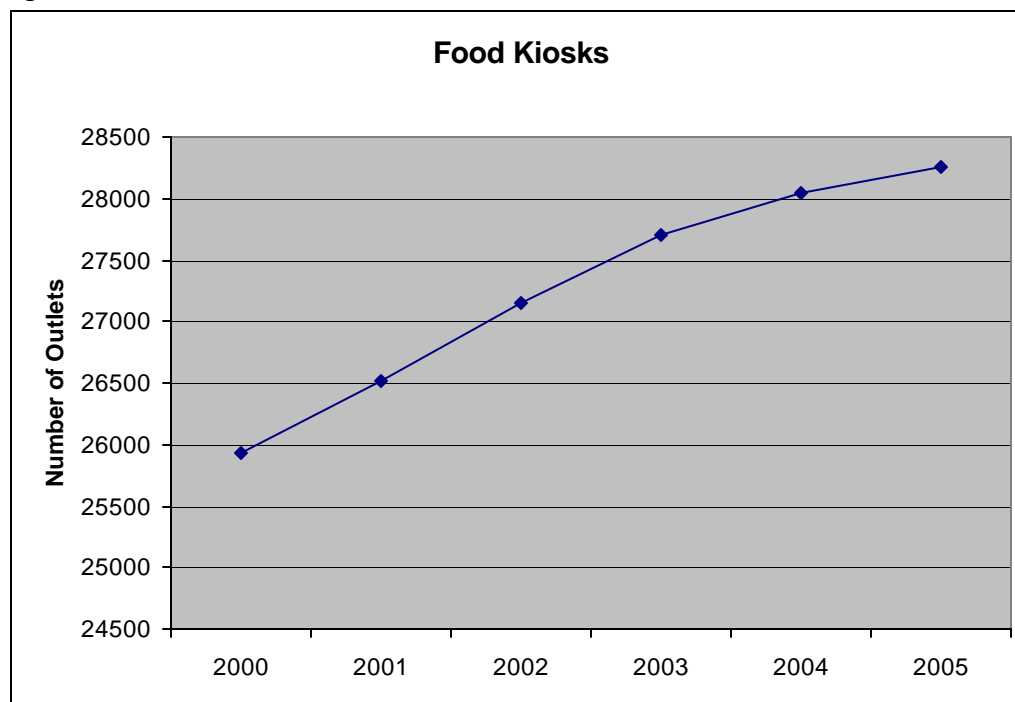
Casual eateries use a variety of imported ingredients, and according to industry experts, imports make up 85% of the products used. Meat, produce, desserts, seasonings, and seafood are the most commonly used imported products. While bread is usually produced in-house, the flours used are often imported. While quality is of some concern, prices dominate purchasing decisions, and U.S. products will need to be cost-competitive to attract business in this segment.

Fast Food

Of all the restaurant sub-sectors, the fast-food category is the fastest growing. Experts report steady growth of sales, generally in the 20-30% range, but some report sales increases of over 100%. Fast food restaurants tend to use a higher percentage of local ingredients (around 50%) compared to other restaurants, but this decision is driven by the high turnover and need for a consistent supply chain more than a direct preference. Several of the fast-food chains have created internal supply chains. McDonald's for example, created McComplex to produce the nearly 56,000 hamburger patties it needs each day in Russia. Produce, dairy and egg products are usually sourced locally, but opportunities for imports do exist. Many chains use imported sauces, breads, and occasionally fruit. Smaller fast-food restaurants that do not have the capital or scale to justify creating their own production facilities may also import meat and some produce. Much of the meat is imported, and then processed in Kaliningrad according to company specifications. Kaliningrad still enjoys import preferences due to its special, economic status. Poultry and beef are the leading imported meats in this category. Most of the larger international chains have an internal distribution network while some of the independent and smaller chains rely on traditional and specialty distributors.

Stand alone kiosks are popular in Russia but there is some consolidation in the industry. The number of independent stands is decreasing, but sales and the number of outlets are increasing. Chains such as Krosha Kartoshka (baked potatoes), Stardog (hot dogs) and Teremok (blinis) are ubiquitous in the major cities and are expanding regionally as well.

Figure 5: Fast Food Kiosks in Russia



Source: Euromonitor and Industry Expert Opinion

Hotels

The hotel industry in Russia is facing a severe room shortage, yet tourism is booming. Moscow has just 6,000 western- business style hotel rooms, and St. Petersburg only 2,000. This pales when compared to other European capitals such as London or Paris, each with 100,000 of such rooms. Other large cities in Russia often have few lodging options other than the old Soviet style hotels. Moscow tourists are expected to reach 5 million in a few years, with St. Pete already close to this number. Vienna has 3 million, and Berlin attracts 3.2 million. St. Petersburg, due to its proximity to Europe, attracts most of the international business travel.

The room shortage is also apparent in the occupancy rates and room tariffs, all of which are high by international standards. Room prices have risen 20% per year since 2000, and a typical room in a Western hotel now goes for over \$300 dollar per night. While hotel operators are pleased with this arrangement, the lack of quality, moderately priced accommodation is blamed for reducing some of the Russia's tourist potential, particularly for business travel. Other sectors such as restaurants and theaters could grow even faster if there were higher tourist capacity.

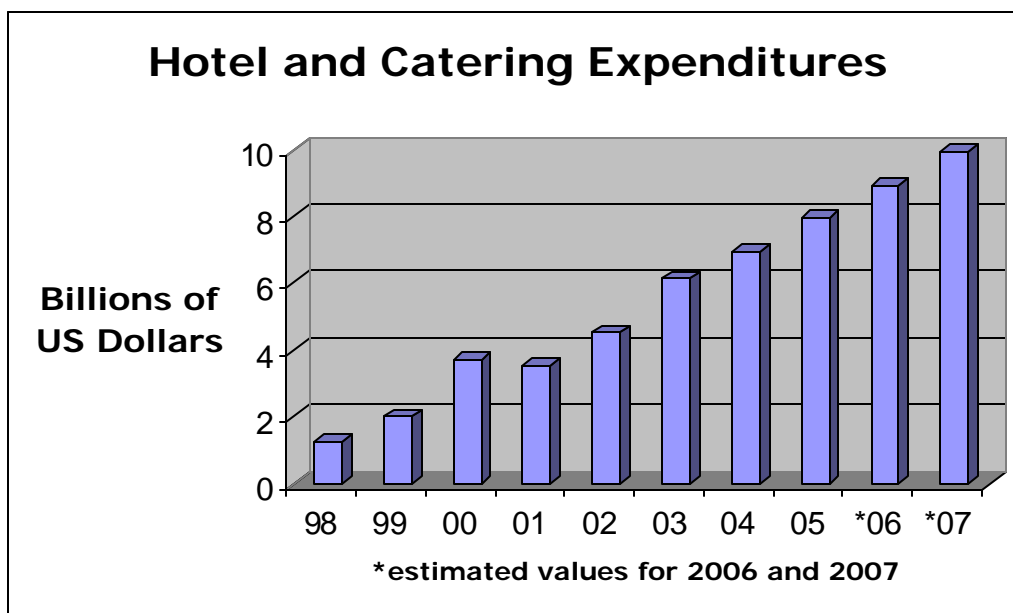
Hotels, however, take time to develop, and the bureaucratic requirements in operating a hotel have slowed the pace of development for large internationally managed hotels. Most internationally branded hotels are operated under management or franchise agreements rather than direct control of their namesake. Business tourism makes up a substantial share of the market, with almost 2 million international visitors per year, in addition to domestic business travel. Business travel has steadily increased, and does not show the same seasonal fluctuations that tourism travel does. The number of business travelers in Russia is forecast to grow by 300% in 2015.

Regions outside of Moscow and St. Petersburg represent a small fraction of the tourist industry, but some areas such as Sochi and Vladivostok are growing quickly. Yekaterinburg, Novosibirsk, Nizhny Novgorod and Kazan are other regions where tourism, particularly business travel, is growing. Major hotel chains are beginning to open facilities in these regions, and the Radisson has just opened an 81 room hotel in Rostov on Don. All in all, 390 new hotels are expected to be built by 2010 across Russia, with many in Moscow, but several in the larger regional capitals.

Luxury Hotels

The luxury hotel market is saturated in Russia, and is concentrated primarily in Moscow and St. Petersburg. These hotels often feature restaurants with internationally recognized chefs, as well as cafes and bars. However, hotel restaurants are rarely profitable, and tourists are seasonal. They cannot rely exclusively on hotel guests, but the local population does not regard hotel restaurants as "real" restaurants, despite a big name chef. Hotel restaurants outside of Moscow and St. Petersburg (such as the new Radisson in Rostov-on-Don) may perform better due to a lack of other dining options.

Figure 6: Hotel and Catering Sales in Russia



Source: Euromonitor

Despite the relatively flat growth in this sub-category, these hotels still represent the best opportunity for American products' sales to hotels, as the other sub-categories usually have very limited food service offerings. Hotel restaurants operate like other restaurants and purchase items through distributors. American meats, wines and spirits are some of the better prospects for this segment.

Mid-Range Hotels

Mid-priced hotels do not usually have restaurant facilities, but may feature limited offerings, particularly breakfast. Most of these hotels are small enough that they purchase their food products from a local cash and carry, or the retail market rather than through distributors. Other hotels contract with a local restaurant to provide food. Price is a very important consideration, and a large percentage of the products are domestically produced.

Budget /Economy

This includes hostels, apartments and dorms. This segment does not offer many opportunities for food service as few provide dining options, and customers in this segment usually rely on fast food, cafes and self-catering.

Institutional

In general, institutions are a challenging segment for American producers. In the past, catering was a miniscule segment of the Russian hospitality market. Catering has enjoyed a 30-70% annual growth rate in the past three years, compare with 13% for other western European nations. Each year, approximately 15 new companies enter the market, and large well-known restaurateurs are getting in on the act. In addition to private events and parties, lunch deliveries are a strong component of the catering business. In Moscow, lunch deliveries accounted for \$64 million dollars in revenue alone. Caterers select products on a variety of categories, depending on the client, and usually work through the same distributors as restaurants. Mid-level and high-end catering uses a variety of imported foods, and catering can present an attractive opportunity for US products, particularly for

specialty items such as seasonings, nuts, meats, wine and seafood. Like restaurants, caterers use a variety of distributors and suppliers depending on their needs.

Office cantinas and cafeterias are another segment that is undergoing change. Until the past few years, most cafeterias were operated in Soviet fashion, with few offerings and generally low quality. The office cantina is now revamping itself as income grows, and people have less time to prepare their own meals. Newer cantinas are offering more and demanding better quality ingredients, but still prefer to buy whole, non-processed items. They are also very price sensitive. Like many restaurants, they monitor prices weekly, and do not hesitate to change suppliers, or menus, when they encounter a better price.

There is no national school lunch program in Russia at present, but there is interest in creating one. Institutional packaging may have some potential in Russia, but the cost and logistics of U.S. products may be a deterrent to potential customers. One bright spot for this trade segment may be rice, peas, beans and lentils. Soup bases, institutional food packs and spices could be interesting to some companies. An annual conference on food service to schools is held each April in Moscow and has growing participation in a trade show from foreign firms offering nutritional foods and food additives, along with the above products.

Railways and airlines are other venues for institutional food service, but these are also limited by budget, and often by domestic purchasing requirements. Operators at the major airports in Moscow usually function as part of a restaurant chain more than an institutional operator. Bulk items that are extremely cost competitive might have potential but face stiff competition from domestic suppliers and cheaper imports from Asia.

Distribution Channel for U.S. products into Russia

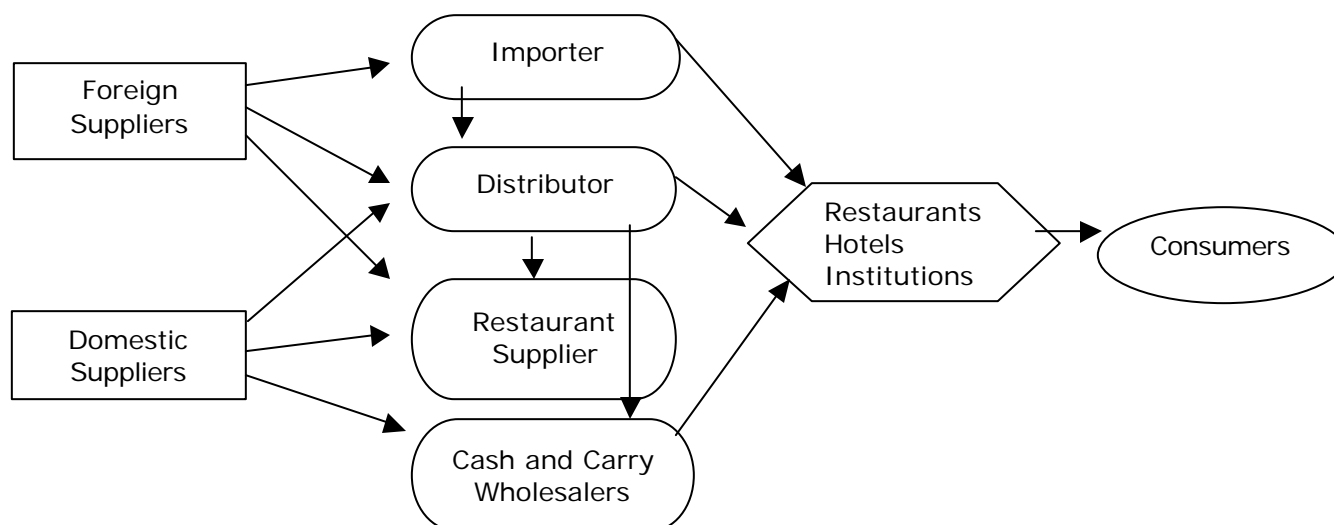
Very few HRI businesses operate on exclusive contracts with vendors, and most change suppliers frequently, particularly if there is a price difference. Most businesses use a separate supplier for each product category (i.e. produce, meat, desserts).

Whole foods are preferred and make up 70% of the sales. Smaller restaurants where space is at a premium are usually the customers for semi-prepared items. Even fast-food chains tend to buy whole produce and slice it at the restaurant level (exceptions to this include meat patties and fries).

Few restaurants rely on fresh produce markets for suppliers. In contrast to U.S. style produce markets, the offerings in Russian markets are inconsistent and of questionable quality. Markets also tend to have higher prices than other supply options.

Section II: Road Map for Market Entry

Figure 7: Distribution Channels for HRI Products in the Russian Market



There are a large number of importers and distributors in the HRI sector, both large and small. A few work across a wide variety of products, but many specialize in a particular category. The distribution market is fragmented, and there are a variety of arrangements between suppliers and customers. As noted above, imports make up with vast majority of HRI products (over 80%), with domestic suppliers filling the gaps.

Figure 8: Advantages and Challenges for US products in Russia

Advantages	Challenges
U.S. products have a reputation for consistency and high quality	Logistics can be difficult
Current exchange rate can make U.S. products less expensive than Euro-zone products	Products need a lot of marketing and educational support to develop a sales base
Brand recognition for some products	Strong competition from Europe and southern hemisphere
HRI market actively seeking new products	Product bans disrupt trade, and can be unpredictable
Regional markets are expanding	Perception of American products as containing hormones or are not natural
HRI sector has a lot of room for growth	Customers are very price sensitive
WTO accession may help market access	Sanitary and Phyto-sanitary bans may allow a continuation of bans

Entry Strategy

Achieving strong sales in the Russian HRI market is not something that can be accomplished without careful planning. However, several meat, fish, seafood, wine, and spirits companies are selling to the HRI sector and their business is growing quickly. Different types of products require different strategies, and U.S. exporters must carefully tailor their approach. The following are things to consider:

- A good relationship with an importer is essential. Negotiating with Russian Customs authorities and phytosanitary processes can be complicated and requires experience.
- Once the goods have been imported, you will usually need a distributor to sell your product. Most HRI companies work through suppliers and distributors and rarely import items directly. The exception to this is international chains that have an internal distribution network within the country. The larger distributors are suited for commodity/ large volume sales. Smaller distributors work well for specialty, high-end, or new products that require marketing and product education. The most promising categories of products fall into this segment.
- Marketing and product education is essential. Many of the industry personnel we spoke with were interested in new products, but want to be shown how to use them, and how the products can be made to work for them. Carefully consider how your product can benefit your target audience. Master classes, and product demonstrations were continually mentioned as stimulating demand for new products. It is also important to include both the distributor and chefs in your promotions. For example, one importer mentioned how a chef had gone to a demonstration, and kept calling the distributor asking if he had "those prawns things they used." The distributor did not know the product, much less the company information, and was unable to provide the product. Many other distributors also mentioned that they want to be shown new products, but do not have time to seek out new products themselves. Exporters would do well to approach importers and distributors and show them their product offerings.
- US producers also need to provide marketing materials appropriate for use in Russia. These do not need to be elaborate. One large distributor mentioned how effective an informational DVD subtitled in Russian was in promoting a product. Translations of printed material, and other electronic marketing materials are essential.
- Participation in trade shows, technical demonstrations, and trade missions to the US are all other elements of marketing strategies that work well in the Russian market. There are two culinary show opportunities of interest in this area, recommended by the ATO: Pir Russia, held each August, and the Vladivostok Culinary Festival held each September. Participation in industry associations (USA Poultry and Egg Export Council, California Almond Board, etc) that have a presence in Russia is also beneficial.
- Logistics must be carefully considered and monitored. Most products will enter Russia through St. Petersburg, but if you are targeting the Russian Far East, Vladivostok is another option. Consistency in the supply chain is frequently mentioned as a primary problem in the HRI segment.
- Marketing will need to be tailored to the targeted sector, just as in the US or EU. Packaging is particularly important. Many distributors reported that their customers prefer clear, vacuum-sealed packaging that allowed them to examine the product. If weights or other information is given on the package, it is critical to ensure that it is correct, as many customers will use this information as a test of a company's reliability.
- Semi-prepared products are not commonly used in the HRI market, however a few restaurateurs are turning to semi-prepared products. If you want to sell semi-prepared foods in Russia, you need to be prepared to do an education program about the benefits and uses of these products. Several distributors believe that this is a growing segment, but that it is in its infancy. The phytosanitary requirements for semi-prepared products can also be more complex, particularly for meat products.
- Negative stereotypes about US products do exist, however, most HRI personnel interviewed said they were more interested in the quality, and price of the food rather than the origin. Negative stereotypes are more pervasive at the retail level, and restaurant consumers are not usually interested in the origin of their entrée.

- Direct importation is difficult without a large customer base so it's best to find an importer. It is essential to have a physical presence here to work with customs.
- Market access is also dependent somewhat on the region, and the desired end customer. If you wish to operate in the Russian Far East, it is far easier to work with an importer and distributor out of Vladivostok rather than St. Petersburg or Moscow.

Major Restaurant Operators in Russia

Chained and franchise restaurants are the exception in Russia, but are quickly becoming the norm. The largest of these, Rosinter, is holding an IPO in May 2007, while the Novikov Group is said to be considering a public offering in 2008. Other international chains work through licensing agreements and franchises. ATO's favorite home grown Russian restaurant, fast food chain is Kroshka Kartoshka. With its distinctive, green kiosks and summer patios, the café's are easy to find around Moscow and a great spot to stop for a baked potato with all the trimmings and a cold beer.

Restaurant Chain	Country of Origin	Year est. in Russia	# Outlets	% Growth from 2005
McDonald's	USA (Canada)	1990	168	15%
KFC*	USA/Russia	1990	20	n/a
Kroshka Kartoshka	Russia (Moscow)	1991	199	26%
Baskin Robbins	USA	1992	134	10%
Rosik's*	Russia (Moscow)	1993	97	8%
Sbarro	USA	1997	90	34%
Teremok	Russia	1998	96	22%
Chainaya Lozhka	Russia (St. Petersburg)	2001	44	32%
Vostochniy Bazaar	Russia (Moscow)	2002	25	40%
Grabli	Russia (Moscow)	2003	3	67%
Edok	Russia (Nizhni Novgorod)	2003	6	n/a
Oliv?e	Russia (Chelyabinsk)	2003	7	n/a
Konopizza	Italy	2005	21	33%
Carl's Jr.	USA	2006	4	100%
Stardog's	Russia (Moscow)	1993 (2003 new brand)	203	4%
Subway	USA	1994(1998)	20	10%
Moo-Moo	Russia (Moscow)	2000	16	n/a

*Joint Venture with Rosinter, co-branding agreement completed in 2006.

Rosinter operates 192 restaurants in 24 cities. Its revenues exceeded US \$219 million dollars in 2006, and they posted a 30% growth rate from 2005-2006. In addition to such Russian brands as Il Patio, Planet Sushi, and 1-2-3 Café, it also holds the license for and operates the T.G.I. Fridays and Benihanas brands (also KFC and Rostiks as shown above).

The Novikov Group is slightly less chain oriented, and operates 30 different high-end concept restaurants, primarily in Moscow. In the past few years, however, it has begun expanding into the democratic and casual sectors with its Yolki-Polki and Kish Mish. They also operate Globus Gourmet, an upscale grocery retailer, and are launching a more mid-priced convenience store with the Yolki-Polki name. It has also announced plans to develop a catering business. Revenue figures from 2005 and 2006 are unavailable, but the Novikov Group reported US \$82 million in sales in 2004. Given the average growth rates, it is reasonable to assume that revenues in 2006 exceeded US \$120 million.

Holding Company	Sales	Brands	Outlets
Rosinter	US \$219 million in 2006 30% growth in 2006	Planet Sushi Il Patio TGI Fridays Benihana 1-2-3 Café	192
Novikov Group	not publicly disclosed	Yolki-Poli Kish-Mish 30 different concept restaurants	est. 100
RP-Com	over US \$50 million in 2006	Goodman Fish House Kolbasoff	20 outlets
Romashka	not publicly disclosed	Shesh Besh John Bull Pub Molly Gwinns Mir Pizza	17 (in 2005)

Source: Industry Data

Competition

Major competition for fruits and vegetables comes from the EU. Many of the eastern European states such as Poland are also significant exporters of bread and bakery products. European companies do not face the port problems that U.S. imports often have, and are able to ship their products over land. Consequently, they can provide perishables in a much faster manner. The major meat competitors come from Brazil (poultry) and Australia (beef), while seafood is imported from Scandinavia and occasionally imported from South American states. While the vast majority of products used in HRI service are imported, there are some ingredients that are usually purchased domestically. These include root vegetables, such as carrots and beets, and other basic vegetables like cabbage. Domestic potatoes are occasionally used, but often as a last resort as the size and quality are too inconsistent for restaurant use.

Wines are often supplied from Italy, France, Spain, and the New World suppliers of Chile, Australia and New Zealand. California wines have made a start here, and this spring seems to have caught on as trendy. Sales of California wines are expanding rapidly. The wine market was up 80 million liters last year in the premium segment, though trade was off for wines from Georgia and Moldova due to trade problems.

Russia's largest suppliers (by sales) of all commodities to food service are Brazil, Germany, the United States, the Ukraine, Argentina, the Netherlands, Poland and China, but no single country dominates the market.

Best Prospects

Several product categories have high potential in the Russian market. Fresh and frozen seafood, frozen and chilled poultry and pork and tree nuts are in demand. Wines and spirits also have high potential, but there is a lack of awareness about American wines. Alcoholic beverages also must comply with special rules regarding alcohol (see GAIN reports RS 7301

and RS 7310). Prepared desserts such as cheesecake (usually frozen) are also in demand, as restaurants often do not have the time or resources to devote to consistently preparing dessert items.

Sauces and seasonings along with semi-prepared items have potential, but need market education. Several industry experts discussed the need for low-fat and reduced calorie dairy items, and bakery preparation items. Frozen breads may have potential, but face competition from European suppliers. Dairy items may face difficulty with customs and SPS requirements.

There is some interest in organic foods, especially as Russia has no certification process for organics. Very few establishments in the HRI sector use or promote organics, but the market may be moving in this direction. The Novikov Group in particular has started marketing its own line of organic dishes in its restaurants.

Some product categories are promising, but current bans prohibit their trade. American beef is strongly in demand, as are potatoes. At present, neither is allowed into the Russian Federation, but the ban on beef may be lifted later this year. Potato preparations, such as semi-prepared fries, are allowed, but whole, raw potatoes are not. If these bans are lifted, these products have significant potential.

Many distributors and importers work throughout Russia. For details on specific product segments, please contact the Agricultural Trade Office for a Buyers List.

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